No. 88-36 (1)

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

BENEFICIAL CORPORATION, FINN M.W. CASPERSEN, ANDREW C. HALVORSEN,

Petitioners,

—against—

ROBERT M. DEUTSCHMAN,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED

Whether the Court of Appeals erred in holding that the purchaser of a call option on a corporation's common stock can sue the corporation and its officers under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder for alleged misstatements, where neither the corporation nor the officers have: (a) traded in the option or the security, (b) consented to the issuance, sale or purchase of the call option, (c) any control over the market for call options, or (d) any relationship to the purchaser of the call option.

PARTIES TO THE PROCEEDING AND RULE 28.1 LIST

The caption of the case in this Court contains the names of all the parties to the proceedings in the court below.

Petitioner Beneficial Corporation has no parent companies or affiliates to list pursuant to Rule 28.1 and all subsidiaries of Beneficial Corporation are either wholly owned or owned in concert with other wholly owned subsidiaries of Beneficial Corporation.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners, Beneficial Corporation ("Beneficial") and two of its officers and directors, Finn M.W. Caspersen and Andrew C. Halvorsen, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in this proceeding on March 7, 1988.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 841 F.2d 502, and is reprinted in the appendix hereto at pages 1a - 14a. The order of the Court of Appeals denying a petition for rehearing and rehearing en banc is not reported, and is reprinted in the appendix hereto at page 29a. The opinion of the District Court is reported at 668 F. Supp. 358, and is reprinted in the appendix hereto at pages 15a-26a.

JURISDICTION

The judgment of the Court of Appeals was entered on March 7, 1988. A timely petition for rehearing and rehearing en banc was denied on April 4, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTE AND RULE INVOLVED

The statute and rule involved in this action, which are set forth in full in the appendix at page 30a, are Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b) ("Section 10(b)") and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 ("Rule 10b-5").

STATEMENT OF THE CASE

The decision below has serious ramifications and constitutes an unprecedented expansion of the scope and applicability of the judicially implied private right of action under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. It is therefore essential that this Court step forward, as it has consistently in the past, to address the requirements that a private litigant must

fulfill in order to maintain a claim for damages under that statute and rule. *E.g. Basic Inc. v. Levinson*, ___ U.S. ___, 99 L. Ed. 2d 194 (1988) (materiality); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (manipulation and deception); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (scienter); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (purchaser/seller requirement).

Specifically, this case presents the question whether the purchaser of a call option on Beneficial common stock can sue Beneficial and two of its officers under Section 10(b) and Rule 10b-5 where the *only* allegations are that the defendants made misstatements affecting the price of the option and the underlying common stock. Importantly, none of the defendants issued the call options, sold the call options, or even traded in the call options or Beneficial's common stock. Moreover, defendants had no control over the type or number of call options issued, and no contractual or other relationship with respondent. Indeed, as explained *infra*, the person who sold the call options to respondent need not have owned Beneficial common stock at the time of the sale.

The right of purchasers and sellers of standardized call options (as well as other derivative securities not issued by corporations) to assert a cause of action for damages against corporations under Section 10(b) and Rule 10b-5 is one of critical importance to U.S. corporations and our capital markets. In 1987 more than $110 billion in options and index options based on the common stocks of major corporations were traded in the United States. *See* SEC Monthly Statistical Review, Vol. 47, No. 3 at 10, 11, 13 (March 1988). To permit traders of these derivative securities to pursue fraud claims under circumstances where the company has no relationship to the option or the purchaser thereof would create the precise

evil this Court warned against in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975): "unduly expansive imposition of civil liability" resulting in "'large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers.'" 421 U.S. at 739 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969)).

A. The Allegations of the Complaint.

Respondent Robert M. Deutschman filed the original complaint in this action in the United States District Court for the District of Delaware on December 22, 1986, naming as defendants petitioners Beneficial Corporation, Finn M.W. Caspersen, its chairman of the board of directors and chief executive officer, and Andrew C. Halvorsen, a director and its chief financial officer. On March 5, 1987, respondent filed an amended complaint naming the same parties as defendants (the amended complaint is referred to herein as the "Complaint").

Respondent alleges that he purchased call options on the common stock of Beneficial through the Pacific Coast Stock Exchange on November 25, 1986 and December 12, 1986 and claims to represent a class of persons, other than petitioners and their affiliates, "who purchased the common stock of [Beneficial] or purchased call option contracts thereon, during the period August 21, 1986 through February 27, 1987." Respondent does not allege that he ever purchased, sold or owned shares of common stock of Beneficial or any other security issued by Beneficial.[1]

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1 Respondent's claim to represent persons "who purchased common stock of Beneficial" is meritless; a plaintiff cannot represent a putative class of which he is not a member.

(Footnote continued)

The Complaint sets forth one cause of action under Section 10(b) of the Exchange Act and Rule 10b-5 and a claim for negligent misrepresentation under state law. The Complaint alleges that petitioners Caspersen and Halvorsen are liable as direct participants, aiders and abettors, or "control persons" under Section 20(a) of the Exchange Act.

Respondent sets forth a number of alleged misstatements which he claims appeared in Beneficial's 1985 Annual Report to Shareholders, letters to stockholders dated August 21 and November 14, 1986, various reports filed with the Securities and Exchange Commission and newspaper articles which appeared in *The Wall Street Journal* on September 2 and December 16, 1986. Respondent does *not* allege that he relied upon or even read any of these statements, or that any of these statements were made to prospective purchasers of call options in order to induce them to purchase their options. Respondent avers only that these public statements affected the prices of the call options he purchased and of Beneficial's common stock. Likewise, the Complaint does not allege that Beneficial, Caspersen or Halvorsen, during the time period complained of, traded in Beneficial stock or in options on Beneficial common stock.

(Footnote 1 continued from previous page)
East Texas Motor Freight System, Inc. v. Rodriguez, 431 U.S. 395, 403 (1977); *Sosna v. Iowa*, 419 U.S. 393, 403 (1975); 3B J. Moore, Moore's Federal Practice ¶ 23.04[2] (2d ed. 1987). This, however, is not an issue at this time since what is at stake here is the question of respondent's standing to pursue his federal securities claims regarding the options.

B. The Proceedings Below

On March 20, 1987, petitioners moved the District Court to dismiss the Complaint, pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, on the grounds that: (i) respondent lacked standing to raise the claims set forth in the Complaint, (ii) the Complaint failed to state a claim upon which relief could be granted, and (iii) there was no pendent jurisdiction over plaintiff's claim of negligent misrepresentation. On July 30, 1987, Chief Judge Murray M. Schwartz granted defendants' motion and dismissed the Complaint. *Deutschman v. Beneficial Corp.*, 668 F. Supp. 358 (D. Del. 1987)(App. 15a-26a)[2], *rev'd*, 841 F.2d 502 (3d Cir. 1988). Judge Schwartz held that: (i) respondent had no standing to assert a cause of action under Section 10(b) of the Exchange Act and Rule 10b-5, and (ii) in light of the dismissal of respondent's federal claims, the District Court lacked jurisdiction over the pendent state law claim. 668 F. Supp. at 364 (App. 25a).

On March 7, 1988, the United States Court of Appeals for the Third Circuit reversed Judge Schwartz, finding that the purchaser of a call option has standing to sue the issuer of the common stock underlying the call option under Section 10(b) of the Exchange Act and Rule 10b-5. *Deutschman v. Beneficial Corp.*, 841 F.2d 502 (3d Cir. 1988)(App. 1a-14a). Relying on its earlier decision in *Peil v. Speiser*, 806 F.2d 1154 (3rd Cir. 1986), and common law tort principles, the Third Circuit utilized the so-called "fraud on the market" approach to establish causation. In so doing, however, the court also

2 References to "App. ___" are to the appendix submitted with this petition.

expanded the scope of liability under Section 10(b) and Rule 10b-5 more broadly than any Court of Appeals, giving the purchaser of *any* security standing to sue *anyone* if he can allege only that the putative defendant's misstatements affected the price of a security the plaintiff purchased. The court failed to recognize that the mere fact that a plaintiff claims to be injured by reason of his purchase of a security (*i.e.*, a call option) is not the end of the inquiry but rather the beginning. While the option is, of course, a "security" it is not a security issued by the defendant corporation and hence, under applicable law, respondent must plead some relationship or transactional nexus to the corporation in order to state a cause of action against it under Section 10(b) and Rule 10b-5. The Court of Appeals, however, simply ignored this legal requirement in reversing the District Court.

On April 4, 1988, petitioners' petition for rehearing with suggestion for rehearing en banc was denied (App. 29a).

C. The Unique Characteristics and Risks of Options and Other Derivative Securities.

Respondent bases his claims upon his trading in standardized call options on Beneficial common stock. As with all derivative securities, these options are not the securities of Beneficial. Indeed, Beneficial is not in any way connected to their issuance or sale, nor does Beneficial receive any proceeds or other consideration from the trading of these options.

1. OCC Options

The options in which respondent traded are standardized options created by The Options Clearing Corpo-

ration ("OCC"), not Beneficial.[3] The OCC defines an option on common stock as "a legal contract that gives the holder the right to buy or sell a specified amount of the underlying interest at a fixed or determinable price . . . upon exercise of the option." OCC Booklet at 4. There are two types of equity options: a "call" option, which gives the holder the right to purchase a specified amount of the underlying security at a fixed price during the term of the option, and a "put" option, which conveys the right to sell at a specified price during the term of the option. *Id.* The price at which the underlying security may be bought or sold is referred to as the "strike" price or exercise price.

Call options are short-term, highly speculative instruments. They are wasting assets and must be exercised before their expiration date or they become valueless. *Id.* at 9, 16. Therefore, an option trader must not only guess correctly about the direction of the price of the underlying stock (*i.e.*, whether it will increase or decrease), but also the timing and extent of that increase or decrease in the stock price. *See id.* at 16-17. In return for this risk, however, the call option trader realizes corresponding opportunities for enormous profits.

While these opportunities can be greatly rewarding, purchasers of call options stand to lose their entire in-

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3 *Characteristics and Risks of Standardized Options* 1 (Sept. 1987) (the "OCC Booklet"). This booklet, issued by the OCC, is the "options disclosure document" which must be furnished by a broker or dealer before accepting an order from a customer, pursuant to SEC Rule 9b-1. *See* 17 C.F.R. § 240.9b-1. The OCC also issues a prospectus which pertains to put and call options.

vestment if the underlying stock does not reach the selected strike price prior to expiration. *Id.* at 16. Selling calls is also risky. The writer (seller) of a call option is paid a "premium," which is described as "a nonrefundable payment -- from the option buyer to the option writer -- for the rights conveyed by the option." *Id.* at 6. The writer takes the risk that if the stock price rises to a point above the strike price, and the option is then exercised, he must sell the underlying stock at the lower strike price. *Id.* at 18. This risk is augmented if the option writer decides to sell "uncovered" or "naked" options -- *i.e.*, options on stock that the trader does not own -- since he may have to buy the stock at a much higher market price and then resell it at the agreed-upon strike price. His liability is therefore potentially limitless. *Id.* at 19-20.

Put and call options are issued by the OCC and, unlike common stock, contribute no equity to the corporation. OCC Booklet at 70-71. The issuer of the underlying common stock is not connected in any way with the writing and trading of standardized options. Rather, the OCC matches the aggregate rights and obligations of option buyers and sellers. Thus, the purchaser must rely on a backup system established by OCC and not any particular option writer for performance. Similarly, the obligations of option writers are owed to OCC rather than to any particular buyer. *Id.* at 70.

Unlike its obligations with respect to its own publicly traded securities, Beneficial has no registration, reporting or disclosure responsibility for options issued by OCC. *See, e.g.*, Sections 12, 13 and 14 of the Exchange Act, 15 U.S.C. §§ 78l, 78m, 78n. *Beneficial has no voice or say in the number or type of options issued, and no contractual or other relationship with either the persons who trade options or the OCC.* As the OCC warns traders of

its options: "Issuers of underlying stocks do not participate in the selection of their stocks for options trading . . ., have no responsibility regarding the issuance, the terms, or the performance of the options . . ., and option holders have no rights as security holders of such issuers." *Id.* at 71.

Beneficial, which has an interest in the trading markets for its publicly traded securities and receives benefits from the public market for its securities, receives no equity or other consideration from the issuance and trading of options on those securities. Indeed, options issued by OCC compete with Beneficial for the investor's dollar. *See Bianco v. Texas Instruments, Inc.*, 627 F. Supp. 154, 159 (N.D. Ill. 1985).

2. Other Derivative Securities

While the decision of the Third Circuit is dramatic in its application to put and call options issued by the OCC, it has implications far beyond that market. As this Court is aware, in recent years the securities markets have seen the proliferation of various new kinds of derivative instruments, such as index options, most of which are based on standardized portfolios of stocks and traded on various exchanges.[4] For instance, both the Philadelphia and the American Stock Exchanges have recently proposed trading of certain index based securities referred to as Cash Index Participations and Equity Index Participations, respectively, in which the purchaser does not trade or have an ownership interest in the underly-

4 For example, the Chicago Board Options Exchange handles options contracts on the Standard & Poors 100. *Report of the Presidential Task Force on Market Mechanisms* 5 (1988).

ing stock, but will, instead, be entitled to cash payments which are equivalent to a proportionate share of regular cash dividends declared on the component stocks of the index. *See* Exchange Act Release No. 25495, 53 Fed. Reg. 10311, 10314 (March 30, 1988); Exchange Act Release No. 25644, 53 Fed. Reg. 16805, 16807 (May 11, 1988). Purchasers will have no rights as security holders in the underlying issuers and, unlike options, there will be no expiration date. The holder will have an opportunity each quarter to "cash-out" his position in addition to receiving a quarterly dividend. 53 Fed. Reg. at 10314, 16807.

These new kinds of instruments bring to the table a whole host of potential new plaintiffs who, under the reasoning of the Third Circuit, are armed with the right to bring damage claims under a statute which never expressly granted any right to sue in the first place. The creation of such liability by judicial implication requires the closest scrutiny by this Court.

REASONS FOR GRANTING THE WRIT

The primary reason this case should be reviewed by this Court is that the Third Circuit decision not only radically and inappropriately expands the scope of liability under Section 10(b) of the Exchange Act and Rule 10b-5, it is in direct conflict with (i) prior decisions of this Court governing the extent to which federal courts may imply a private right of action under the federal securities laws and (ii) a decision of the United States Court of Appeals for the Eighth Circuit, which squarely refused to adopt the rule now embraced by the Third Circuit in this case, as well as decisions of district courts in at least three other circuits. As a result, the decision below has transformed an apparently clear area of the law into one filled

with contradiction and uncertainty, which only this Court can resolve.

I

THE DECISION BELOW CONFLICTS WITH EXISTING LAW

A. The Decision Is In Conflict With Prior Rulings Of This Court.

The issue in this case is not whether the facts alleged in the Complaint would, under appropriate circumstances, form a basis for penal sanctions or an action for injunctive relief by the Securities and Exchange Commission. Instead, this case presents solely the question of whether an option trader, who is a complete stranger to the corporation, should be permitted to sue the corporation for money damages. In answering this question in the affirmative the Third Circuit has implied a cause of action where none exists by ignoring or misapplying the careful criteria established in *Cort v. Ash*, 422 U.S. 66 (1975). The result is a ruling which is in conflict with the prior decisions of this Court and potentially dangerous.

As this Court has repeatedly emphasized "the fact that a federal statute has been violated and some person harmed does not automatically give rise to a private cause of action in favor of that person." *Cannon v. University of Chicago*, 441 U.S. 677, 688 (1979); *accord Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11, 24 (1979); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979). Instead a court must look carefully at the specific factors enumerated in *Cort v. Ash* to determine whether a cause of action can properly be implied. This is particularly true where, as here, the newly-

created claim may involve critical implications for our courts and our capital markets; unfortunately, the Third Circuit failed to follow this Court's teachings.

The first, and most important factor under *Cort v. Ash* is whether the plaintiff is one of the class for whose "*especial* benefit" the statute was enacted. *Cort v. Ash*, *supra*, at 78; *Cannon v. University of Chicago*, *supra*, at 689-94. Put another way, is the statute sufficiently protective of some special group so as to give rise to a private cause of action by a member of that group?[5] Applied to the Exchange Act, this Court has sanctioned a private right of action only where there is a pervasive legislative scheme governing the relationships at issue between the plaintiff group and the defendant. *Compare Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977) (defeated tender offeror does not have standing to sue for money damages under Section 14(e) of the Exchange Act because that section is intended to protect stockholders of the target) *with J.I. Case & Co. v. Borak*, 377 U.S. 426, 431-33 (1964) (finding a private right of action by stockholders for violation of the proxy rules). Here, there plainly is no such scheme, as well as no such relationship between the plaintiff and defendants.[6]

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5 It is not enough that the statute provides penal sanctions intended to protect some individual, social or public interest (*Cort v. Ash*, 422 U.S. at 79-81) or that the statute might provide a private right of action to other plaintiffs or even the same plaintiff in other circumstances (*Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 37-39 (1977)).

6 There is, of course, a very specific relationship between the corporation and its security holders, as spelled out in the Exchange Act. For example, Sections 12 and 13(a) of the Exchange Act require a corporation to file a registration statement containing specified information if its securities are traded on a national securities exchange and to publish and file period-

(Footnote continued)

Clearly, the purchaser of a call option, who does not purchase either an option from the corporation or an option issued by the corporation, cannot be said to be part of a "pervasive legislative scheme" because in fact there is no such scheme. Similarly where, as here, the option holder alleges only that claimed misstatements affected the price of the call option purchased, it is hard to imagine how plaintiff could assert that he is part of any class for whose "especial benefit" Section 10(b) was designed. And, as this Court noted in *Cannon v. University of Chicago*, there is "far less reason to infer a private remedy in favor of individual persons" where the statute is merely phrased in prohibiting terms, as here, instead of with "an unmistakable focus on the benefited class . . . ." 441 U.S. at 690-91. In short, it is peculiarly inappropriate to imply a cause of action in this case.

(Footnote 6 continued from previous page)
ic reports to holders of such securities. 15 U.S.C. § 78l, 78m(a). Section 14 of the Exchange Act requires a corporation to make certain disclosures to holders of its equity securities where proxies are solicited or other shareholder action is sought or a tender offer for those securities is made. *Id.* § 78n. Similarly, Section 13(d) requires holders of more than five percent of a corporation's equity securities to make certain disclosures to the corporation and other holders of the corporation's securities. *Id.* § 78m(d). These detailed obligations running between a corporation and its security holders stand in stark contrast to the lack of any such obligations between Beneficial and persons who are not holders of the company's securities, such as respondent. None of the registration, reporting and disclosure obligations requires disclosure to holders of options or requires any option holder to make disclosure to the corporation. They are total strangers to each other.

This conclusion is not only mandated by the teaching of *Cort v. Ash*, it is in accord with other decisions of this Court determining the parameters of the right of action under Section 10(b) of the Exchange Act and Rule 10b-5 -- standing to sue must stem from some relationship or transactional nexus between the parties. *See, e.g.*, *Chiarella v. United States*, 445 U.S. 222, 230 (1980) ("liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction"); *Dirks v. SEC*, 463 U.S. 646, 657-58 (1983); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977); *see also SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968) (the connection with a purchase or sale requirement is satisfied, provided that the misstatements are "of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase and sell *a corporation's securities*") (emphasis added), *cert. denied*, 394 U.S. 976 (1969).

The Third Circuit ignored the analytical standard for creating causes of action as well as the settled principles set forth in the Rule 10b-5 cases cited above. Instead, the court created its own two-step approach: first, it invoked the common law tort rule which imposes liability if a defendant violates a statute and causes injury to plaintiff; and second, because there was no allegation that respondent relied on any of the petitioners' alleged misstatements, the court utilized the causation principle embodied in the so-called "fraud on the market" theory to supply the requisite element of reliance or causation. 841 F.2d at 507 (App. 11a-12a). *See Peil v. Speiser, supra*. In so doing the Third Circuit was again clearly in error.

First, tort principles alone can never justify implication of a private right of action. *Touche Ross v. Reding-*

ton, supra, at 568; *see also Cannon v. University of Chicago, supra*, at 688. Second, the court's use of the "fraud on the market" theory to impose liability on corporations in favor of those who trade options on the corporation's securities conflicts with this Court's recent decision in *Basic Inc. v. Levinson*, ___ U.S. ___, 99 L. Ed. 2d 194 (1988).

In *Basic*, this Court held that a purchaser of a *corporation's* securities could sue the company for damages based on alleged misstatements and omissions, so long as the plaintiff alleged reliance on the integrity of the market. ___ U.S. at ___, 99 L. Ed. 2d at 215 (quoting *Peil v. Speiser, supra*, 806 F.2d at 1160-61). But the entire premise of the theory -- that a purchaser is relying on a fair market to reflect a fair price -- is inapplicable here. The very nature of an instrument like a call option -- which requires the purchaser to gamble on the direction that the market will take -- is that the purchaser is relying not on the market's integrity but, rather, on his own belief that the market price of the underlying common stock is *not* reflective of its true value. *See Zlotnick v. TIE Communications*, 836 F.2d 818, 822-23 (3d Cir. 1988). Thus, the fraud on the market theory simply has no legal or logical application here and the Third Circuit's failure to understand that constituted error.

To summarize briefly, the lower court failed to apply the correct standard for implying causes of action and instead created its own ill-founded approach. By so doing, the court rendered a decision which is in direct conflict with the prior rulings of this Court and, as such, should not be allowed to stand.

B. The Opinion Conflicts With A Recent Decision Of The Eighth Circuit And Decisions In Other Federal Courts.

Despite some earlier decisions to the contrary, *e.g.*, *In re Digital Equip. Corp. Sec. Litig.*, 601 F. Supp. 311 (D. Mass. 1984); *Lloyd v. Industrial Bio-Test Laboratories*, 454 F. Supp. 807 (S.D.N.Y. 1978), the clear weight of authority, including a decision by the Court of Appeals for the Eighth Circuit, is that option traders do not have standing to sue the corporation which has issued the underlying common stock for damages under Section 10(b) of the Exchange Act and Rule 10b-5. *E.g.*, *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983); *Data Controls North, Inc. v. Financial Corp. of America*, ___ F. Supp. ___, 1988 U.S. Dist. LEXIS 4602 (D. Md. 1988); *Tolan v. Computervision Corp.*, C.A. No. 85-1396-N (D. Mass. December 8, 1987) (Magistrate's Report and Recommendation); *Starkman v. Warner Communications, Inc.*, 671 F. Supp. 297 (S.D.N.Y. 1987); *Bianco v. Texas Instruments, Inc.*, 627 F. Supp. 154 (N.D. Ill. 1985).

In *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983), the Court of Appeals for the Eighth Circuit reached a result in direct conflict with the decision below. In that case, plaintiff, a purchaser of call options on General Dynamics common stock, alleged that General Dynamics purchased shares of its common stock without disclosing a pending dividend. Finding a lack of fiduciary duty or similar relationship of trust between an issuer of common stock and the holder of options on that stock, the district court dismissed the complaint.

In affirming the district court the Eighth Circuit, citing this Court's decision in *Chiarella v. United States*, 445 U.S. 222 (1980), found that

> plaintiff fail[ed] to demonstrate that [defendant] . . . owed any special duty to the plaintiff who merely held an option to buy [defendant's] stock from a third party. There simply existed no relationship of trust and confidence between the parties. As *Chiarella* makes clear, "liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction*."

704 F.2d at 411-12 (citation omitted) (emphasis added by the court); *see also Dirks v. SEC*, 463 U.S. 646, 657-58 (1983) ("We reaffirm today that '[a] duty [to disclose] arises from the relationship between parties'") (quoting *Chiarella* at 231 n.14). The Eighth Circuit observed that while the corporation and its officers and directors assume a fiduciary duty to the buyer of the corporation's stock, the same cannot be said *vis a vis* the purchaser of options. 704 F.2d at 412. "They were still complete strangers and ordinarily no duty would be owed." *Id.* The court observed that the corporation had never entered into any contract with the options trader, had neither issued, sold or purchased options, nor had any control over the issuance or trading in options -- in stark contrast to the corporation's relationship with its own common stock. *Id.* at 411. Further, the court noted that

> "The relationship between corporate insiders and shareholders stands in stark contrast to the lack of relationship between the corporate insiders and options traders. . . . [T]he dispositive distinction is that *the*

> *options trader has no equity interest in the corporation by virtue of his selling or purchasing an option on the corporation's stock. He is owed no special duty by the officers and directors of the corporation because, quite simply, the corporation is not run for his benefit.* He has contributed no equity to the corporation and, in the event of insider wrongdoing, he has no right to bring suit to make the corporation whole."

704 F.2d at 411 (quoting *O'Connor & Assoc's* v. *Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1184-85 (S.D.N.Y. 1981) (emphasis added)). In sum, the court held, "[w]e find there must be some special relationship between plaintiff and defendant before a duty of disclosure arises. Here there is none." 704 F.2d at 413.

The Third Circuit attempted to distinguish *Laventhall* on two bases, neither of which has any merit. First, the court tried to characterize *Laventhall* as an insider trading case in which, under this Court's decision in *Chiarella*, there was no transactional nexus between the alleged nondisclosure and the market for options. 841 F.2d at 507 (App. 10a-11a). In addition, the Third Circuit attempted to forge a meaningful distinction between the nondisclosure alleged to have occurred in *Laventhall* and affirmative misrepresentations. *Id.* (App. 11a). The Third Circuit is plainly wrong on both counts.

First, there is no way to wedge the holding of *Laventhall* into a narrow insider trading niche. In *Laventhall*, the plaintiff's alleged injury stemmed from the fact that General Dynamics failed to disclose to holders of call options a pending dividend on its common stock. Plaintiff then sold his options without knowledge of that pending dividend. If the reasoning of the Third Circuit

were correct, the Eighth Circuit's *Chiarella* analysis in *Laventhall* was superfluous because the simple causal nexus between the alleged nondisclosures and the injury to the sellers of the call options should have been enough to state a cause of action. But the Eighth Circuit's *Chiarella* analysis was not superfluous, and that court correctly reasoned that some transactional nexus or relationship, in addition to mere causation, must be present to impose liability to purchasers or sellers of call options for false and misleading statements under Section 10(b) of the Exchange Act and Rule 10b-5. Since that transactional nexus or relationship is as absent in this case as it was in *Laventhall*, the decisions of the Third and Eighth Circuits simply cannot stand side by side. If the Third Circuit is correct that a corporation is liable for false and misleading statements to a purchaser of any security in any market, then *Laventhall* was incorrectly decided.

The Third Circuit's view that *Laventhall* is also distinguishable because the case dealt with nondisclosures rather than misrepresentations is also wrong. Such a distinction misconstrues the *Laventhall* decision. First, the Eighth Circuit made no such distinction. Second, no such distinction can or properly should be made in these kinds of cases because a misrepresentation of fact is in reality no more than the nondisclosure of the true fact. *See Little v. First California Co.*, 532 F.2d 1302, 1304 n.4 (9th Cir. 1976); *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730, 739 (W.D. Va. 1982); *Sullivan v. Chase Inv. Serv., Inc.*, 79 F.R.D. 246, 262 (N.D. Cal. 1978). In other words, attempting to force the result in these cases by divining whether there was a "nondisclosure" or an affirmative erroneous disclosure is to trivialize the analysis and to enter a legal never-never land. The Eighth Circuit did no such thing.

The standing limitations on purchasers of call options enunciated in *Laventhall* were based on the lack of any relationship between parties, not on whether the defendant allegedly engaged in omissions or misrepresentations. Because option traders "stand in the same structural relationship" or lack thereof to the issuing corporation, whether there was disclosure or nondisclosure, *see In re McDonnell Douglas Corp. Sec. Litig.*, 567 F. Supp. 126, 127 (E.D. Mo. 1983), there can be no standing in either case.[7] Moreover, the Third Circuit's misrepresentation/omission distinction is unworkable as a practical matter. To cite one example, in the Complaint plaintiff alleges both misrepresentation and nondisclosures. Complaint ¶¶ 52, 53. Presumably, according to the Third Circuit, plaintiff would now have standing to sue for the alleged misrepresentations but not for the alleged nondisclosures. This, we submit, makes no sense because, as the Third Circuit recognized in *Peil v. Speiser*, *supra*, omissions can have the same effect on the market price of a security as misrepresentations. 806 F.2d at 1162. By ignoring that fact in this case and creating a new misrepresentation/omission distinction, the Third Circuit has produced a circumstance where the ability to generate massive and expensive litigation would amount to nothing more than a pleading exercise. This, we submit, is senseless.

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7 *See also Bianco v. Texas Instruments, Inc.*, 627 F. Supp. 154, 161 (N.D. Ill. 1985) ("We do not agree that the distinction between affirmative misrepresentation and nondisclosure calls for a different rule as to the standing of options traders to sue under § 10(b). Instead, we read *Chiarella* and its progeny as indicating that there must be some relationship, or some connection between the plaintiff and the § 10(b) defendant.").

In sum, no matter how hard the Third Circuit strained to do so, its decision cannot be reconciled with the holding in *Laventhall*, let alone the spate of lower court decisions which have recognized that option holders do not have standing to sue in these circumstances. Accordingly, it is vital that this Court resolve the conflict and put the matter to rest.

II

STRONG POLICY REASONS REQUIRE THAT OPTION TRADERS BE DENIED STANDING UNDER SECTION 10(b) AND RULE 10b-5

As this Court has observed, even when the factors enumerated in *Cort v. Ash*, *supra*, are satisfied, courts have the further obligation to consider the defendants' "countervailing arguments" of a policy nature which weigh against implication of a private right of action. *See Cannon v. University of Chicago*, 441 U.S. at 689, 709-712. Here, the Third Circuit rejected the strong policy reasons favoring a limitation on the potential liability of corporations to option traders, stating that such concerns were either incorrect or not matters for the courts. 841 F.2d at 507-08 (App. 11a-13a). The fact is that the concerns are serious and militate strongly in favor of a result which imposes sensible limitations on the class of potential plaintiffs. Moreover, since the private right of action under Section 10(b) and Rule 10b-5 is the result of judicial implication, this kind of expansion should be of major concern to this Court.

A. Option Traders Contribute Nothing To The Corporation.

The Third Circuit declared itself "not willing to construe section 10(b) as inapplicable to option contracts on the basis of speculation about the relationship between option contracts, market liquidity, and capital formation." 841 F.2d at 508 (App. 13a). While the effect of options in creating market liquidity may be debated, there is no speculation required as to their role in capital formation. Options have no role in capital formation. Common stock represents an investment in the corporation. Common stock is issued to raise capital and it represents an ownership interest in the corporation. Options do none of these things, and as to that there can be no serious argument.

The fact that options traders are not investors in the corporation was considered an important policy factor by the court in *Bianco v. Texas Instruments, Inc., supra*:

> Options traders . . . are not investors in the corporation making misleading statements, nor do they purchase or sell that corporation's securities. Their transactions in options contracts are simply too remote to satisfy the "in connection with" requirement when the alleged deceptive acts are merely corporate misstatements not directed in any way to the options market.

627 F. Supp. at 161. The court went on to dismiss plaintiff's counter argument that this result would encourage corporate fraud by noting that "whatever deterrent purpose is served by § 10(b) and Rule 10b-5 will be amply fulfilled by restricting liability for misrepresentations

and omissions to persons trading in the common stock of the corporation." *Id.*

The inherent inequity of providing a cause of action against a corporation for losses suffered by an option trader is made plain by the fact that the corporation has no control over whether options are even issued, let alone in what amount. While the corporation can decide how many shares of common stock to issue, "issuers of underlying stocks do not participate in the selection of their stocks for options trading . . . [and] have no responsibility regarding the issuance, the terms, or the performance of the options . . . ." OCC Booklet, *supra*, note 3, at 71. If the Third Circuit's decision is not reversed, a corporation is subject to virtually unlimited liability over which it would have no control.

B. The Third Circuit's Opinion Forces A Corporation's Stockholders To Pay For Reducing The Risks of Option Traders.

The result reached by the Third Circuit is also fundamentally unfair. Contrary to the Third Circuit's claim, 841 F.2d at 507 (App. 11a-12a), the limitations on potential plaintiffs by virtue of the "actual purchase or sale" requirement of the *Birnbaum* rule or the proximate cause requirement of *Peil v. Speiser*, are not sufficient. If someone dealing in *any* security can plead only some "but for" causal connection, no matter how tenuous, between his loss and alleged misstatements by a putative defendant, then liability under Rule 10b-5 is limited only by the imagination of the financial industry in creating new security instruments based in any way on a corporation's performance. *See Bianco*, *supra*, 627 F. Supp. at 161 ("potential liability to options holders is

limited only by the whims of the options writers").[8] For the courts to give that kind of blank check to the creators of new securities, with the corporation ultimately acting as the banker, is frightening.

As several courts have recognized, the vast expansion of the class of potential plaintiffs will result in judgments and litigation costs that will be borne squarely by those who were intended to be protected by the securities laws, namely the stockholders of the corporation. *E.g.*, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969); *Starkman v. Warner Communications, Inc.*, 671 F. Supp. 297, 307 (S.D.N.Y. 1987); *Bianco v. Texas Instruments, Inc.*, 627 F. Supp. 154, 161 (N.D. Ill. 1985). The perverse irony of the Third Circuit's ruling is that the "especial class" sought to be protected by the Exchange Act would, instead, be directly burdened by the Rule. *See Piper v. Chris-Craft Indus., Inc.*, *supra*, at 39.

The real vice created by the Third Circuit, however, is that the expense to stockholders of financing the litigation the lower court's decision will spawn is not limited to those cases where the corporation is ultimately found to have violated the securities laws. As this Court has recognized, "litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from

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8 As the Third Circuit points out, options have been traded for years, but their use was limited until the advent of the Chicago Board Options Exchange in 1973. Since then options on over 400 stocks are traded, with a volume of over 118 million contracts. 841 F.2d at 504 (App. 5a).

that which accompanies litigation in general." *Blue Chip Stamps*, 421 U.S. at 739.

> The first of these concerns is that in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.

Id. at 740. Without proper limitations on the class of plaintiffs who can bring securities actions against corporations, inefficiencies and misallocations of capital will no doubt result. Each decision regarding disclosure must be made with the fear of exposure to "liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179-180, 174 N.E. 441, 444 (1931) (Cardozo, C.J.), *quoted with approval in Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 748 (1975).

The Third Circuit also misperceived the petitioners' argument regarding the speculative nature of options trading. Petitioners do not contend, as the court stated, that because option traders are "'gamblers' . . . they are fair game for affirmative misrepresentation while stock traders are not." 841 F.2d at 507 (App. 12a). Rather, petitioners maintain that because option traders have made a decision to invest their money not in Beneficial -- which investment would carry with it certain inherent

rights, protections and duties running to the investor -- but in a different security known for its high risk and its potentially high profits, *see generally* OCC Booklet, *supra*, note 3, they are not entitled to the same protection as stockholders, at the stockholders' expense.

Petitioners are not asking this Court to hold option traders are "fair game." Indeed, it is difficult to see any reason why Beneficial would care about the price at which options on its securities were trading. The point is that it is appropriate to hold Beneficial responsible to those who have invested in it and to limit its responsibility to those who have not. The result reached by the Third Circuit now makes corporations "fair game." An investor who purchases options which later expire without value will no doubt be encouraged by the result below to invest in a new venture -- a lawsuit against the corporation for alleged misstatements which, when coupled with the usual boilerplate class action allegations, will then provide the option investor with a new asset whose settlement value is limited only by the amount of ruinous damages that can be pleaded.

Finally, and ironically, the Third Circuit has bestowed upon the holders of options the same protection for which stockholders have paid a premium, thus reducing the option trader's risk at the expense of stockholders. Corporations and their investors are, as a result, now even more subject to the long-recognized danger "that a slip of the pen or failure properly to amass or weigh the facts -- all judged in the bright gleam of hindsight -- will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). The intent behind Rule 10b-5 was "not to establish a scheme of inves-

tors' insurance," much less to establish a scheme to insure a new class of non-investors. *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). Yet the Third Circuit, with its decision in this case, has done exactly that. Such a result, especially in the face of a decision by another Court of Appeals in conflict with the result below, requires review by this Court.

CONCLUSION

For the foregoing reasons Petitioners respectfully submit that the petition for a writ of certiorari should be granted and the case set for oral argument.

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DATED: July 5, 1988

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 87-3570

ROBERT M. DEUTSCHMAN.
Appellant

v.

BENEFICIAL CORP.,
FINN M. W. CASPERSEN.
ANDREW C. HALVORSEN

(D.C. Civil No. 86-00595)

ON APPEAL FROM THE UNITED STATES DISTRICT
COURT FOR THE DISTRICT OF DELAWARE

Argued: January 20. 1988
Before: GIBBONS *Chief Judge*, and
WEIS and GREENBERG. *Circuit Judges*

(Opinion Filed: March 7. 1988)

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OPINION OF THE COURT

GIBBONS, *Chief Judge.*

Robert M. Deutschman appeals from a Fed. R. Civ. P. 12(b)(6) dismissal of his amended class action complaint against Beneficial Corporation (Beneficial), Finn M. W. Caspersen, Beneficial's Chairman and Chief Executive Officer, and Andrew C. Helvorsen, its Chief Financial Officer. The two count complaint alleges that the defendants violated (1) section 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b),78t(a) (1982), and (2) the state common law of negligent misrepresentation. Deutschman, a purchaser of call options on Beneficial stock, seeks to act as a class representative for purchasers of such call options and for purchasers of Beneficial stock. The district court held that the purchaser of a call option lacks standing to sue under the Securities Exchange Act, and is thus not an appropriate class representative for purchasers of Beneficial stock. Because the federal claim was dismissed on standing grounds, the pendent state law claim was dismissed as well. We will reverse.

Since the order appealed from granted a Rule 12(b(6) motion, we accept as true the factual allegations of Deutschman's amended complaint. Deutschman alleges that in 1986 and part of 1987 Beneficial's insurance division suffered severe losses which had an adverse impact on Beneficial's financial condition; that Caspersen and Halversen held stock and stock options in Beneficial which would be adversely affected by a decline in the market price of that stock; that disclosures were made about the losses in Beneficial's insurance division which caused declines in that market price; that in order to prevent further declines Caspersen and Halversen, on Beneficial's behalf,

issued statements about the problems in the insurance division, which they knew to be false and misleading, to the effect that those problems were behind it and were covered by sufficient reserves; that these misleading statements placed an artificial floor under the market price of Beneficial stock; that purchasers of Beneficial stock and purchasers of call options in Beneficial stock made purchases at prices which were artificially inflated by the market's reliance on defendant's misstatements, and that both purchasers of Beneficial stock and purchasers of Beneficial call options suffered losses as a consequence. Beneficial stock is traded on the New York Stock Exchange and on other national stock exchanges. Options on Beneficial stock are traded on the Pacific Stock Exchange. The complaint does not allege that Beneficial, Caspersen, or Halversen, during the time period complained of, traded in Beneficial stock or in put or call options on Beneficial stock. It alleges that Deutschman suffered losses when, upon disclosure of the facts, call options on Beneficial's stock that he had purchased in reliance on the market price created by defendants' misstatements, became worthless. It does not allege that Deutschman purchased Beneficial stock.

The district court held that option traders who suffered losses as a result of intentional misstatements by the management of a corporation, the stock of which is the subject of those options, lack standing to assert a cause of action for damages under section 10(b) of the 1934 Act, 15 U..C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5. The court reasoned that in the absence of an allegation that Deutschman bought or sold Beneficial stock, or of an allegation that the defendants bought or sold options, there was no duty owed to him

to refrain even from affirmative misstatements which would affect the market price of Beneficial stock.

Put and call options have been a feature of the national financial markets since 1790. Under these contracts a seller agrees to sell or a purchaser agrees to buy a security at a fixed price on or before a fixed date in the future. Such contracts permit investors to hedge against future movements in the market price of securities. Prior to the early 1970's the utility of put and call options was limited because of high transaction costs, and because of the absence of a secondary market for the option contracts. In 1973, the Chicago Board Options Exchange became the first registered exchange for trading in option contracts. Within a short time that exchange had been joined by the American, Philadelphia, Pacific, and Midwest exchanges. By 1985, those exchanges were trading options on over 400 stocks, and the volume of contracts traded exceeded 118.6 million. *See* Green, Stock Option Trading Gains Popularity as Takeovers and Hedging Spur Surge, *Wall St. J.*, July 23, 1986, at 35, col. 1.

The option contract gives its owner the right to buy (call) or sell (put) a fixed number of shares of a specified underlying stock at a given price (the striking price) on or before the expiration date of the contract. For this option a premium is paid, and the contract is worth more or less than the premium depending upon the direction of the market price of the underlying stock relative to the striking price. The market price for options is directly responsive, therefore, to changes in the market price of the underlying stock, and to information affecting that price. *See generally*, Rubenstein, An Economic Evaluation of Organized Option Markets, 2 J. of Comp. Corp. Law and Sec. Reg. 49 (1979).

Because the market value of an option contract is responsive to changes in the market price of the underlying stock, holders of option contracts are susceptible to two separate types of deceptive practices: insider trading and affirmative misrepresentation. Insiders trading on undisclosed material information can injure option holders either by market activity which causes the price of the underlying stock to move, or by market activity directly in the options market. Insiders or others who do not trade in either market can injure option holders by misstating material facts to the public, thereby causing a distortion in the market price of the underlying security, and in the necessarily related market price of the option contract. Only the second type of harm is pleaded by Deutschman: affirmative misrepresentation by corporate managers having the effect of artificially supporting the market price of the underlying stock, and concomitantly the market price of the option contract for that stock.

Section 10(b) prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b). The relevant SEC rule provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made,

in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1987). The defendants do not deny that the affirmative misrepresentations pleaded by Deutschman would, if proved, amount to untrue statements of material fact which would operate to deceive a purchaser of Beneficial stock. The complaint alleges that the misrepresentations were made intentionally or with reckless disregard of the truth. It, therefore, satisfies the section 10(b) scienter requirement. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Thus defendants do not dispute that even though they did not trade in Beneficial stock they could, if Deutschman's allegations are proved, be held liable in a suit by a purchaser of such stock. *See, e.g., Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986) (stock purchaser can recover damages under section 10(b) for misstatements by corporation and its officers); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) (seller can recover under section 10(b) for loss on sale induced by corporation's misleading press release). Finally, defendants do not dispute that Deutschman is a purchaser of a security. Congress placed that question beyond debate when, in the Act of Oct. 13, 1982, P.L. 97-303, § 2, Stat. 1409, it amended the Securities and Exchange Act of 1934 and other federal statutes so as explicitly to include option contracts.[1] In contrast with

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1. 15 U.S.C. § 78c(a)(10) currently provides:

The term "security" means any note, stock, treasury

the cause of action for sale of unregistered securities under section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1934 Act), "a § 10(b) action can be brought by a purchaser or seller of '*any* security' against '*any* person' who has used '*any* manipulative device or contrivance' in connection with the purchase or sale of a security." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983) (emphasis in original).

The only standing limitation recognized by the Supreme Court with respect to section 10(b) damage actions is the requirement that the plaintiff be a purchaser or seller of a security. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 959 (1952). When in *Manor Drug Stores* the Supreme Court adopted the *Birnbaum*

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stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, *any put, call, straddle, option, or privilege on any security*, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing, but shall not include currency or any note, draft bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

The italicized language was added by Pub. L. 97-303.

requirement that a section 10(b) plaintiff be a purchaser or seller of a security, however, it expressly recognized that such plaintiffs need not be in any relationship of privity with the defendant charged with misrepresentation. 421 U.S. at 745. The underlying purpose of the 1934 Act was the protection of actual participants in the securities markets, and the *Birnbaum* rule was consistent with that purpose because it limited "the class of plaintiffs to those who have at least dealt in the security to which the prospectus, representation, or omission relates." *Id.* at 747.

Deutschman's complaint appears, therefore, to satisfy every requirement for a section 10(b) damage action imposed by the Supreme Court when dealing with affirmative misrepresentations which may affect the market price of a security. The district court nevertheless dismissed it. The court acted in reliance on *Chiarella v. United States*, 445 U.S. 222 (1980), and *Dirks v. Securities & Exchange Comm.*, 463 U.S. 646 (1983), construing those cases as limiting exposure to liability for damages under section 10(b) to persons in some special relationship of trust or confidence toward the section 10(b) plaintiff.

The district court's reliance on *Chiarella* and *Dirks* is entirely misplaced. Those cases dealt not with injury caused by affirmative misrepresentations which affected the market price of securities, but with the analytically distinct problem of trading on undisclosed information: a theory of recovery which Deutschman does not plead. The "disclose or abstain from trading" rule laid down in the insider trading cases imposes on insiders a duty to disclose information which need not otherwise be disclosed before they act on that information in any uninformed marketplace. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d. Cir.

1968), *cert. denied*, 394 U.S. 976 (1969). Market participants who are neither insiders nor fiduciaries of another type need not disclose material facts, but can rely on the assumption that all other participants have equal access to information. *See General Time Corp. v. Talley Industries, Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969). *Chiarella* and *Dirks* involve only the question of when outsiders and nonfiduciaries will be treated as insiders or fiduciaries for purposes of the affirmative duty to disclose or refrain from trading. The court in those cases declined to extend the duty to disclose or abstain to mere tippees who came into possession of otherwise undisclosed information. Nothing in those opinions, however, can be construed to require the existence of a fiduciary relationship between section 10(b) defendant and the victim of that defendant's affirmative misrepresentation. Except to the extent that other federal statutes may have imposed a disclosure obligation (none are relied on by Deutschman), Beneficial and its officers were free to keep quiet about its business affairs so long as they stayed out of the market. According to Deutschman, however, they chose to speak, and in speaking they were not free to lie.

The district court also relied upon *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983), a case which we find quite distinguishable. In *Laventhall* no misstatements were made to the public. Instead, the defendant corporation, without disclosure, traded in its own securities after a decision had been made to change its dividend policy. The plaintiff option trader sought to hold the corporation liable for the loss he incurred in the options market because he purchased without knowledge of the impending change in the dividend

policy. The Court of Appeals for the Eighth Circuit held that he could not recover on an insider trading theory of liability absent some transactional nexus between the nondisclosure and the market for options. *Id.* at 412. The reasoning of the *Laventhall* case with respect to insider trading liability has been tellingly criticized. Note, *Private Causes of Action for Option Investors under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis*, 100 Harv. L. Rev. 1959 (1987). We need not address that criticism here, however, for the *Laventhall* holding, like the *Chiarella* and *Dirks* holdings, is simply not relevant to the distinct issue of affirmative misrepresentations affecting a market in securities. No Supreme Court case and no Court of Appeals case has ever imposed a transactional nexus requirement in a section 10(b) affirmative misrepresentation case. *But see Bianco v. Texas Instruments*, 627 F.Supp. 154 (N.D. Ill. 1985) (corporation not liable to option trader for affirmative misrepresentation). *Compare In re Digital Equip. Corp. SEC Litig.*, 601 F. Supp. 311 (D. Mass. 1984) (corporation liable to option trader for affirmative misrepresentation); *Lloyd v. Industrial Bio-Test Laboratories*, 454 F.Supp. 807 (S.D.N.Y. 1978) (same).

The defendants urge, nevertheless, that policy reasons require that they be insulated from liability to option traders because otherwise there would be no end to their liability. This argument is chimerical. When in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the Supreme Court adopted the *Birnbaum* rule limiting section 10(b) plaintiffs to purchasers or sellers of securities, it confined section 10(b) liability to members of the precise class for the protection of which the 1934 Act was enacted: participants in the national securities markets. Options traders are participants in those markets. The

same degree of protection against unlimited liability to that class as is afforded with respect to other kinds of tortious conduct is also afforded to the defendant by the proximate cause requirement delineated in cases such as *Piel v. Speiser*. 806 F.2d 1154 (3d Cir. 1986). The spector of unlimited liability to persons outside that class was exorcised by the Supreme Court in *Manor Drug Stores*.

Another policy argument advanced by the defendants is that although purchasers of option contracts do purchase securities they are entitled to less protection under the 1934 Act because option trading, like blackjack or craps, is "gambling." By characterizing option traders as "gamblers" the defendants hope that we will draw the conclusion that they are fair game for affirmative misrepresentation, while stock traders are not. We are not persuaded that the difference between trading in the two types of securities should lead to different treatment. Since the price of option contracts is closely dependent upon the price of the underlying stocks, the degree of risk involved in trading in one over the other is not self-evidently greater. The time element of a put or call option does increase exposure to price movements, but the ability to buy or sell such options in the interim does not. Moreover, the availability of option contracts permits traders in common stocks to engage in hedging transactions, which are often used as means of reducing exposure to market fluctuations and are thus risk reducing. This method of risk reduction, formerly available only through put and call options in an over-the-counter market, has since 1973 been available at lower cost. Finally, it is not our role as a court to pass judgment on the soundness of the legislative policy judgments which led to the creation of exchanges for option contracts, and their treatment as

securities. Congress, the Securities and Exchange Commission, the Board of Governors of the Federal Reserve System, and the Commodity Futures Trading Commission all have had a role in the evolution of the market for these securities, and the policy judgment was their responsibility, not ours.

A final point advanced in support of the district court's ruling is that option traders are not entitled under section 10(b) to protection against affirmative misrepresentation because they play no role in capital formation. We are willing to assume, arguendo, that a chief reason for federal regulation of securities markets is that the existence of those markets, post-issue, tends to make capital available to issuers of securities. It is not at all clear to us, however, that the options contract market contributes to liquidity in the post-issue market in a manner significantly different than does the market for stocks, especially when margin trading of stocks is taken into account. Thus we are not willing to construe section 10(b) as inapplicable to option contracts on the basis of speculation about the relationship between option contracts, market liquidity, and capital formation. The legislative policy judgment in this respect is not ours to make.

We hold that Deutschman has standing as a purchaser of an option contract to seek damages under section 10(b) for the affirmative misrepresentations he alleges were made by the defendants, Beneficial, Caspersen, and Halvorsen. The judgment dismissing Deutschman's section 10(b) claim must therefore be reversed. Since Deutchman's pendent state law claim was dismissed only because jurisdiction was predicated on 28 U.S.C. § 1331, the dismissal of that claim must also be reversed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF DELAWARE

Civil Action No. 86-595 MMS

ROBERT M. DEUTSCHMAN,

Plaintiff,

—v.—

BENEFICIAL CORPORATION, FINN M. W. CASPERSEN, and ANDREW C. HALVORSEN,

Defendants.

PAMELA S. TIKELLIS, ESQ. of Biggs & Battaglia, Wilmington, Delaware; *Of Counsel*; RICHARD B. DANNENBERG, ESQ., Richard Bemporad, Esq., and Jill Raskin, Esq., of Lowey, Dannenberg & Knapp, P.C., New York, New York; *attorneys for plaintiff Robert M. Deutschman.*

CHARLES F. RICHARDS, JR., ESQ., SAMUEL A. NOLEN, ESQ., and KEVIN G. ABRAMS, ESQ., of Richards, Layton & Finger, Wilmington, Delaware; *attorneys for defendants Beneficial Corporation and Finn M. W. Caspersen*; *Of Counsel*; Dewey, Ballantine, Bushby, Palmer & Wood, New York, New York, *for defendant Finn M. W. Caspersen.*

STEPHEN P. LAMB, ESQ., of Skadden, Arps, Slate, Meagher & Flom, Wilmington, Delaware; *attorney for defendant Andrew C. Halvorsen.*

OPINION

Dated: July 30, 1987
Wilmington, Delaware

MURRAY M. SCHWARTZ, Chief Judge

The last decade has been one of dramatic change and growth in the securities market. One evolution has been the emergence and dynamic rise of trading in options. Not surprisingly, the options market has spawned a host of legal issues. The pivotal question treated in this opinion is whether options traders have standing to bring a cause of action under section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5.

Plaintiff Robert M. Deutschman, an options trader, on November 25 and December 12, 1986, purchased listed call option contracts on the common stock of defendant Beneficial Corporation ("Beneficial") at a cost of $14,229. On December 16, 1986, the option contracts had lost 99.8 percent of their value. On December 22, 1986, plaintiff filed a complaint and on March 5, 1987, filed an amended complaint naming Beneficial as a defendant along with Finn M.W. Caspersen and Andrew C. Halvorsen, respectively chairman of the board of directors and chief executive officer of Beneficial. The amended complaint is based on sections 10(b) and 20(a) of the 1934 Act, 15 U.S.C. §§ 78j(b), 78t(a), and Rule 10b-5.

Count I of the amended complaint alleges with specificity that defendants made a series of materially false and misleading statements to the investing public, by means of their own statements and reports and through the news media, regarding Beneficial's reinsurance business and loss reserves. Plaintiff alleges defendants violated a duty owing to options traders because defendants either knew or should have known the statements were false when made or failed timely to correct these statements when they knew or were reckless in not knowing the statements were no longer true.

The amended complaint also asserts defendants Caspersen and Halvorsen may be held liable as direct participants, aiders and abettors, or "control persons" under section 20(a) of the 1934 Act. Count II of the amended complaint, relying on pendent jurisdiction, asserts a state law claim for negligent misrepresentation.

The amended complaint states that as a result of adverse disclosures to the investing public on December 16, 1986 "the market price of Beneficial common stock dropped some 20%. On December 16, 1986, the common stock closed at $57 1/8 after trading as low as $54 3/4, having precipitously declined some 20% from its December 12, 1986 closing price of $65." Docket Item 7, ¶ 41. Plaintiff goes on to note that "[t]he market price of Beneficial common stock . . . continued to fall in December, opening on December 19, 1986 at $56, $3 below the close on December 18, 1986, and trading as low as $54.75" and alleges that "the market price of Beneficial common stock would have plunged even further if defendants had not sought to cover up the difficulties suffered in the Company's reinsurance business." *Id.* ¶ 43. The decline in market value of Beneficial shares rendered plaintiff's option contracts worthless.

The amended complaint is also noteworthy for what it does not contain. It is devoid of any allegation that plaintiff had any relationship whatsoever with Beneficial. It makes no allegation that plaintiff ever purchased, sold, or owned shares of Beneficial common stock. Plaintiff does not allege that Beneficial consented to the issuance, purchase, or sale of call options on its common stock on any securities exchange, or that Beneficial was in any way connected with plaintiff's purchase or sale of call options. Nor does the amended complaint allege plaintiff dealt with Beneficial—directly or indirectly—at any time. Finally, plaintiff does not allege that any defendant traded in the options market or bought or sold Beneficial shares during the critical time period when the nondisclosures or misrepresentations were made and the adverse news surfaced.

On March 20, 1987, defendants filed a motion to dismiss the amended complaint. Dismissal under Fed. R. Civ. P. 12(b)(6) is improper unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle

him to relief. *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). Moreover, the Court must accept as true the allegations of the amended complaint, *Cruz v. Beto*, 405 U.S. 319 (1972), and construes them favorably to plaintiff. *Scheuer v. Rhodes*, 416 U.S. 232 (1974).

The motion to dismiss squarely presents the question of whether an options trader has standing to assert a cause of action under section 10(b) of the 1934 Act and SEC Rule 10b-5, where it is not alleged that any of the defendants traded in the underlying stock or in options on the stock. The cases are sharply divided. *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983); *Bianco v. Texas Instruments*, 627 F. Supp. 154 (N.D. Ill. 1985); and *In re McDonnell Douglas Corp. Sec. Litig.*, 567 F. Supp. 126 (E.D. Mo. 1983), hold options traders lack standing. *See Etshokin v. Texasgulf, Inc.*, 612 F. Supp. 1220 (N.D. Ill. 1985). *In re Digital Equip. Corp. Sec. Litig.*, 601 F. Supp. 311 (D. Mass. 1984); *Backman v. Polaroid Corp.*, 540 F. Supp. 667 (D. Mass. 1982); and *Lloyd v. Industrial Bio-Test Laboratories*, 454 F. Supp. 807 (S.D.N.Y. 1978), conferred standing on options traders. In making the standing determination, "[w]e are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited . . . ." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749 (1975). The Court must address whether the "judicial oak which has grown from little more than a legislative acorn," *id.* at 737, should be engrafted with a new limb from which numerous branches would inevitably sprout. For the reasons that follow, I conclude that options traders lack standing under section 10(b) and Rule 10b-5.

Some background explanation of options is essential to understanding the question of whether options traders have standing to assert a Rule 10b-5 violation.[1] The type of stock options plaintiff Deutschman purchased were call options. The call op-

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1 The summary explanation in the text is gleaned from Seligman, *The Structures of the Options Market*, Fall 1984, Journal of Corporate Law 141. A more comprehensive examination of the options market is contained in that article.

tions, or options to buy, gave plaintiff the right, but not the obligation, to buy Beneficial shares at a preset price. Call options are sold by an options writer who must deliver stock if and when a call option is exercised. The options writer, usually found on a regional options exchange, is paid a premium by options purchasers to assume the obligation to deliver the underlying stock. In this case, plaintiff paid a premium of $14,229 for fifty-five option contracts, which conferred upon him the right to receive 5,500 shares of Beneficial stock.

The purchaser of a call option has two ways to profit from the trading in options on the secondary market. The option may be exercised, earning a profit if the market price of the underlying security exceeds the sum of the exercise price, the premium, and transaction costs. Alternatively, if the price of the underlying security increases the option contract may be sold, earning a profit if the sale price of the contract exceeds the sum of the original premium and transaction costs. The latter alternative is by far the most frequently employed method of earning a profit on options.

Options are a highly leveraged way of making profit by correctly predicting the direction and extent of movement in a particular stock.[2] By the same token, trading in options is far more speculative than purchase of the underlying stock because of the definite and short duration of the contract. If a call option contract cannot be sold because the price of the underlying stock did not rise as far as anticipated, all or part of the premium may be lost.

Defendants argue that because there is no transactional or fiduciary relationship between the options trader and the issuer of the underlying stock, the issuer owes no duty to the options trader under section 10(b) and Rule 10b-5. Defendants rely on *Chiarella v. United States*, 445 U.S. 222, 228-30 (1980), in which the Supreme Court held that a duty to disclose material information arises only if a "relationship of trust and confidence" exists between the defendant and the injured party. The

2 Assuming an average market price per share of $65 during the period in which Deutschman purchased his 55 option contracts, he would have paid $357,500 for the underlying Beneficial stock. Thus, for $14,229 (ignoring a differential in transaction costs), Deutschman was leveraged 25 to one.

defendant in *Chiarella* was a printer who inferred the identity of a corporation that was the target of a takeover attempt from a document sent to his employer for printing. Using this confidential information, the defendant purchased shares in the target corporation, and then sold the shares at a profit immediately after the takeover was made public. The Court found the defendant did not violate section 10(b) and Rule 10b-5, although he purchased shares with improperly obtained inside information, because he was not a corporate insider and was not a fiduciary or agent of the injured sellers. *Id.* at 232-33; *see Dirks v. Securities & Exch. Comm'n*, 463 U.S. 646 (1983).

In *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983), the Eighth Circuit Court of Appeals relied on *Chiarella* in holding that no relationship existed between options traders and the issuer of the underlying stock where the issuing corporation trades in the stock without disclosing material inside information. Although the corporate defendant in *Laventhall* had violated section 10(b) and Rule 10b-5 as to persons also trading in the corporation's stock, there was no "transactional nexus" between the corporation and the plaintiff options traders. *Id.* at 412. Without this transactional nexus, the court held that the duty to disclose does not arise absent "some special relationship" between the plaintiff and defendant in a securities fraud case. *Id.* at 413.

The *Laventhall* rule has been applied to dismiss an action brought by options traders against the issuer of the underlying stock where the issuing corporation traded neither in options nor in the stock, but simply failed to disclose material adverse information. *See In re McDonnell Douglas Corp. Sec. Litig.*, 567 F. Supp. 126 (E.D. Mo. 1983). More importantly for purposes of the instant case, standing has also been denied to options traders where the issuer of the underlying stock engaged in affirmative misrepresentations as opposed to mere nondisclosure. *See Bianco v. Texas Instruments*, 627 F. Supp. 154 (N.D. Ill. 1985). *But see In re Digital Equip. Corp. Sec. Litig.*, 601 F. Supp. 311 (D. Mass. 1984); *Backman v. Polaroid Corp.*, 540 F. Supp. 667 (D. Mass. 1982); *Lloyd v. Industrial Bio-Test Laboratories*, 454 F. Supp 807 (S.D.N.Y. 1978). This Court agrees that securities fraud actions brought by options traders against

issuers of the underlying stock must be dismissed regardless of the type of misconduct alleged.

There is a vast difference between corporate shareholders and options traders. Shareholders own an equity interest in the corporation; options traders do not. Shareholders are involved in desired capital formation; options traders make no contribution to capital or a contribution so attenuated as to be *de minimis*. Although both shareholders and options traders are affected by the corporation's performance, the brute fact is the corporation is run only for the benefit of shareholders, not options traders. The relationship between shareholders and the corporation is one of trust and confidence, giving rise to a duty owed by the corporation. The nonexistence of a relationship between options traders and the corporation precludes such a duty.

In addition to the duty analysis, the Supreme Court's decision in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), squarely supports the denial of standing to options traders.[3] The plaintiffs in *Blue Chip* were offerees of a stock offering made pursuant to an antitrust consent decree. They alleged that affirmative misrepresentations and nondisclosures by the defendant offeror fraudulently induced the offerees not to purchase the stock. The Court denied standing, holding that a private damages action under section 10(b) and Rule 10b-5 is confined to actual purchasers or sellers of securities. *Id.* at 747-49.

Options traders are, of course, purchasers or sellers of securities as the term "security" is defined by section 3(a)(10) of the 1934 Act. 15 U.S.C. § 78c(a)(10); *see Blue Chip*, 421 U.S. at 750-51. The conclusion that plaintiff in the instant case has satisfied the purchaser or seller requirement of *Blue Chip*, how-

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3 Other cases in addition to *Blue Chip* and *Chiarella* arguably portend a pronounced trend in the Supreme Court to restrict causes of action under section 10(b) and Rule 10b-5. *See* Aaron v. Securities & Exch. Comm'n, 446 U.S. 680 (1980) (scienter required in SEC injunction actions); Santa Fe Indus. v. Green, 480 U.S. 462 (1977) (no Rule 10b-5 liability for corporate mismanagement or breach of fiduciary duty claims); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (scienter required in Rule 10b-5 damages actions).

ever, does not follow from this premise. *Blue Chip* can only be read as requiring that the plaintiff in a section 10(b) case be an actual purchaser or seller of securities *issued by the defendant corporation*. The call options purchased by plaintiff are securities within the meaning of the 1934 Act, but they are not securities in Beneficial. Like the plaintiffs in *Blue Chip*, plaintiff Deutschman is "a complete stranger to the corporation," 421 U.S. at 755, without standing to assert a section 10(b) violation.

Notwithstanding the obstacles erected by *Chiarella* and *Blue Chip*, plaintiff appears to assert four discrete theories in support of his claim.[4] First, plaintiff alleges defendant is engaged in "manipulative or deceptive" acts in violation of section 10(b) of the 1934 Act. The short answer to this contention is that section 10(b) proscribes manipulative and deceptive acts only "in connection with the purchase or sale of any security." 15 U.S.C. § 78j(b). Similarly, Rule 10b-5 only prohibits fraudulent acts "in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. There is no allegation that defendants either traded in options on Beneficial stock during the period in question or directed to the options market their alleged misrepresentations and nondisclosures. Plaintiff's trading in option contracts is "simply too remote to satisfy the 'in connection with' requirement when the alleged deceptive acts are merely corporate misstatements [and nondisclosures] not directed in any way to the options market." *Bianco v. Texas Instruments*, 627 F. Supp. 154, 161 (N.D. Ill. 1985).

4 Plaintiff argues in addition that the interest of options traders in being protected against securities fraud is within the "zone of interests" surrounding section 10(b), and that Congress has therefore conferred standing on plaintiff. *See* Association of Data Processing Serv. Orgs. v. Camp, 397 U.S. 150 (1970). The "zone of interests" test, however, has been applied principally where plaintiffs seek to review administrative action under the Administrative Procedure Act, and is inapposite where Congress has manifested an intent to narrow the class of persons who may sue. *See* Clark v. Securities Indus. Assoc., 55 U.S.L.W. 4111, 4114 n.16 (1987) ("the invocation of the zone of interest test . . . should not be taken to mean that the standing inquiry under whatever constitutional statutory provision a plaintiff asserts is the same as it would be if the 'generous review provisions' of the APA apply").

Second, plaintiff argues section 10(b) imposes a duty of disclosure that derives from a common law duty to disclose where a corporation has made prior statements on a topic. Therefore, the argument goes, defendants were under a duty to speak the whole truth when undertaking to speak at all and a duty to correct or revise a prior statement that was accurate when made but which became misleading in light of subsequent events. The obvious weakness of this theory is that establishing a duty of disclosure sheds no light on the question of to whom the duty is owed.

Third, plaintiff relies on the "fraud on the market" theory, stated in the amended complaint and recently adopted by the Third Circuit Court of Appeals, to establish a duty owed to option traders. In *Peil v. Speiser*, 806 F.2d 1154 (3d Cir. 1986), the Court of Appeals explained:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. The misstatements may affect the price of the stock, and thus defraud purchasers who rely on the price as an indication of the stock's value. By artificially inflating the price of the stock, the misrepresentations defraud purchasers who rely on the price as an indication of the stock's value. *The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.* In both cases, defendants' fraudulent statements or omissions cause plaintiffs to purchase stock they would not have purchased absent defendants' misstatements and/or omissions.
>
> Accordingly, we hold that plaintiffs who purchase in a open and developed market need not prove direct reliance on defendants' misrepresentations *but can satisfy their burden of proof on the element of causation* by showing that the defendants made material misrepresentations.

Id. at 1160-61 (citation and footnote omitted; emphasis added). The price of call options is closely tied to the price of the underlying stock; the Court therefore assumes without deciding the fraud on the market theory would be applicable to claims by options traders. Moreover, plaintiff properly alleges that defendants' materially false and misleading statements artificially inflated the price of call options on Beneficial stock just as they artificially inflated the price of the stock itself.

Pleading the fraud on the market theory, however, does not give rise to a duty owed by defendants to options traders. The theory is no more or less than an alternative method of proving the causal connection between misrepresentations and nondisclosures, on the one hand, and the plaintiff's injury, on the other. It has no bearing on the relationship between options traders and the issuer of the underlying stock that must exist before the causation element can even come into play. I hold that the fraud on the market theory does not impose on Beneficial a duty owing to plaintiff.

Fourth, plaintiff asserts that defendants owed a duty to the investing public, which includes options traders. As I understand plaintiff's theory, it is based on the unarticulated premise that the federal securities laws have created an absolutely level playing field in which all investors have a right to all information necessary to make investment decisions. Plaintiff reasons that his right as a member of the investing public was violated because defendants' misrepresentations were aimed at the securities market in general,[5] and it was foreseeable that the investing public would rely on them.

Several weaknesses plague plaintiff's duty to the investing public theory. Beneficial, like other corporations on whose stock options are traded, does not control the number of option contracts that may be written; its potential liability to options traders is limited only by the business judgments of options writers. As Chief Judge Cardozo observed, caution is the watchword where the creation of a duty results in "a liability in

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5 In support of this claim, plaintiff alleges that the misrepresentations were not confined to corporate letters or reports to shareholders, but were also in articles in the Wall Street Journal and press releases intended for the investing public in general.

an indeterminate amount for an indeterminate time to an indeterminate class." *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931). Moreover, if plaintiff is granted standing in this case, the ultimate recovery could only be paid by Beneficial and its shareholders. Such an expansion of corporate liability "will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers . . . ." *Securities & Exch. Comm'n v. Texas Gulf Sulphur Co.* 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). There is no reason why options traders, who have chosen a greater risk in exchange for the prospect of a greater return, and who do not meaningfully contribute to capital formation, should recover at the expense of the corporation's shareholders. Finally, restricting liability for misrepresentations and nondisclosures to purchasers and sellers of the corporation's stock amply serves the deterrent purposes of section 10(b) and Rule 10b-5. *See Bianco v. Texas Instruments*, 627 F. Supp. 154, 161 (N.D. Ill. 1985).

For the foregoing reasons, I respectfully disagree with the holdings of *In re Digital Equip. Corp. Sec. Litig.*, 601 F. Supp. 311 (D. Mass. 1984); *Backman v. Polaroid Corp.*, 540 F. Supp. 667 (D. Mass. 1982); and *Lloyd v. Industrial Bio-Test Laboratories*, 454 F. Supp. 807 (S.D.N.Y. 1978). I hold that an options trader is without standing to assert a cause of action under section 10(b) of the 1934 Act and SEC Rule 10b-5, where it is not alleged that the defendants traded in the underlying stock or in options on the stock. An order will be entered dismissing Count I of the amended complaint.[6] The order will also dismiss for lack of jurisdiction the pendent state law claim in Count II of the amended complaint. *See United Mine Workers v. Gibbs*, 383 U.S. 715 (1966).

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6 The claim against defendants Caspersen and Halvorsen under section 20(a) of the 1934 Act, of course, falls with the claim against Beneficial.

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF DELAWARE

Civil Action No. 86-595 MMS

ROBERT M. DEUTSCHMAN,

Plaintiff,

v.

BENEFICIAL CORPORATION, FINN M. W. CASPERSEN, and ANDREW C. HALVORSEN,

Defendants.

ORDER

At Wilmington this 30th day of July, 1987, for the reasons set forth in the Opinion issued this date,

IT IS ORDERED:

1. Count I of the amended complaint is dismissed.

2. The pendent state law claim in Count II of the amended complaint is dismissed for lack of jurisdiction.

/s/ MURRAY M. SCHWARTZ
United States District Judge

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 87-3570

ROBERT M. DEUTSCHMAN,

Appellant

—v.—

BENEFICIAL CORP. FINN M. W. CASPERSEN
ANDREW C. HALVORSEN

(D.C. Civ. No. 86-00595)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE -- DISTRICT OF DELAWARE

Present:

GIBBONS, *Chief Judge*
WEIS and GREENBERG, *Circuit Judges*

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the -- District of Delaware and was argued by counsel January 20, 1988.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court entered July 30, 1987, be, and the same is hereby reversed. Costs taxed against the appellees.

ATTEST:

SALLY MRVOS, *Clerk*

March 7, 1988

Certified as a true copy and issued in lieu of a formal mandate on April 12, 1988.

Test: M. ELIZABETH FERGUSON

Chief Deputy Clerk, U.S. Court of Appeals for the Third Circuit.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 87-3570

ROBERT M. DEUTSCHMAN,

Appellant

—v.—

BENEFICIAL CORPORATION, FINN M. W. CASPERSEN,
ANDREW C. HALVORSEN

SUR PETITION FOR REHEARING

Present: GIBBONS, *Chief Judge*, SEITZ, WEIS, HIGGINBOTHAM, SLOVITER, BECKER, STAPLETON, MANSMANN, GREENBERG, HUTCHINSON, SCIRICA, AND COWEN, *Circuit Judges*.

The petition for rehearing filed by appellant in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court en banc, the petition for rehearing is denied.

By the Court,

JOHN J. GIBBONS
Chief Judge

Dated: April 4, 1988

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, Title 15, United States Code

§ 78j. Manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5, Title 17, Code of Federal Regulations

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.